

Financial Managers update

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Liquidity strategy

Managing liquidity risks is paramount

Managing liquidity risks in today's troubled economic environment remains an ongoing challenge for institutions that are struggling to prosper, a banking strategist warns.

The magnitude of credit risks currently facing banks, thrifts and credit unions has changed the game for everybody, making a well thought out, forward-looking strategy more important than ever.

"It has put in a whole new dynamic of liquidity risk management, and it's one of the key things that I think has caught a lot of people off guard, including the regulators," says Mike Guglielmo, Managing Director, Darling Consulting Group, Newburyport, Mass.

Shifting pressures

The situation has become more and more serious, due to the shifting pressures weighing down on institutions. The ability to access funds easily through various alternatives has changed, as the liquidity pool has shrunk due to tightening standards and supply-demand factors.

Guglielmo, who made his comments during a recent FMS webinar, explained that in the past year, large industry players were hoarding liquidity, putting pressure on prices and on smaller institutions' liquidity lines.

In the last few months, however, the situation has evolved again, with some institutions that were previously in need of funding currently "awash with liquidity."

So, given the fast changing environment, it's essential for CFOs to ensure they are taking adequate steps to manage their liquidity effectively.

"Ultimately, you need to be more prepared than you have in the past," Guglielmo said.

Not surprisingly, liquidity risk management is now getting heightened scrutiny from examiners. They are evaluating the ability of institutions to maintain access to funds, and have issued comprehensive guidance in the past year addressing both liquidity risks and contingency funding.

"Examiners are armed with new expectations and handbooks," Guglielmo warned. "In some instances, they're really over-doing it—so it's really incumbent upon you to educate yourselves as much as you can as to what they're trying to get at."

He cited four major liquidity risk-management concerns among examiners that CFOs must address. First, they have been reacting to a "convergence" of operational and contingency liquidity sources.

Guglielmo explained that many of the traditional wholesale sources of funding that formerly were considered to be "contingency" resources are now used by many institutions as operational sources of liquidity. He cited the funding resources available through the Federal Home Loan Bank and Federal Reserve as examples.

"More and more banks are relying on those as operational sources, and so the examiners' question—and it's a valid one—is: now what?" he said. "What is the ultimate backstop, what is your catastrophe insurance, and how much of your powder is dry?"

Volatile markets

Second, examiners are concerned that institutions have become dependent upon volatile capital markets for funding without undertaking the appropriate amount of measurement and management for the prevalent risks involved. "They want to be certain that you have a process in place that can help you to measure your own liquidity risk components," he said.

Third, they see a lack of forward-looking measurement and discussion concerning liquidity. In the current environment, examiners want institutions to ensure that the liquidity process looks ahead at least six months, discerning future needs and challenges.

"Most institutions that we encounter are not doing a good job on forward thinking," he said.

He advised that if CFOs can formulate at least a 90-day to six-month forecast on expectations of cash flows and future liquidity needs, it would go a long way towards satisfying regulators.

Fourth, examiners are concerned about the limited preparedness at institutions to meet liquidity contingencies that could arise, due

to significant volatility in financial markets.

Managements need to develop liquidity contingency action plans, taking into account the unique situation at their own institutions. To do this, it's essential for managers to understand how the institution's liquidity profile can change as a result of both local and national systemic pressures.

Guglielmo offered a few best practices. He indicated that successful institutions are reassessing and strengthening their liquidity-risk management processes, and are adopting more robust collateral management and reporting techniques, liquidity forecasting in 30- to 100-day windows, stress testing, and the use of liquidity "scorecards" to better monitor activity.

Unfortunately, he pointed out that most institutions are not doing liquidity stress testing, and feels that such testing could become as important as interest rate risk.

In addition, successful institutions are expanding their contingency funding plans, working on liquidity scenario definitions and "triggers," documenting potential management responses to liquidity challenges, and adjusting liquidity processes more frequently following reviews of the contingency plan. All are items that examiners are beginning to expect.

Testing lines

Guglielmo also stressed the need for institutions to test liquidity lines. "If you don't test your lines, you don't have them," he said.

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*Mike Guglielmo, Managing Director
Darling Consulting Group
Newburyport, Mass.*

Don't take for granted that what is promised is always available. On a quarterly basis, or at the very least, yearly, you should attempt to access all your lines so that you are comfortable with the contingency plans you have in place, he advised.

He also recommended that institutions take a look at the Federal Reserve's Term Auction Facility (TAF), a temporary credit facility designed to allow depository institutions to bid

on term funds from their local Federal Reserve Bank. "Think of it as similar to an e-Bay for banks," Guglielmo said.

The minimum Term Auction Facility bid is \$5 million with additional bid increments of \$100,000. Basic terms that are available are 28 days and 84 days, which can vary slightly by holidays, and the interest rate charged is determined by auction. All collateral that is accepted at the Fed's discount window is accepted here, he explained.

Interested FMS members may review Guglielmo's remarks, which are available in an on-demand webinar that can be accessed by going to the FMS web site. In addition, members also may gain additional insights concerning liquidity management strategies in the Industry News Archive on the FMS web site at www.fmsinc.org.

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